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SUBJECT: Earthquake Dents Japan's Auto Industry

11. (SBU) Summary. The July 16 earthquake off Niigata affected the Japanese auto industry nationwide. Production recovered relatively rapidly, however, and industry sources tell us that lost production will be made up by year end. Companies' all-important bottom lines will only be minimally affected, if at all.

The quake provoked some criticism of the industry's vaunted just-in-time lean production system and anxieties over the vulnerability of manufacturing supply chains. The auto industry and METI claim the system worked as designed: maintaining low inventories and a flexible workforce, hallmarks of the lean production system, proved to be the most cost-effective way to manage risk. In the future, the auto industry will be hedging its bets and looking to disperse production around Japan and abroad. The dominant position of Japan in key manufacturing areas and the concentration of production in certain companies and plants create the lingering possibility that a major natural disaster in Japan could affect manufacturing globally. End summary.

The Effect of the Earthquake on Auto Production -----

12. (U) The earthquake off Niigata on July 16 shook the auto industry all over Japan. Riken Company's Kashiwazaki plants in Niigata prefecture produce fifty percent of the piston rings used by vehicle manufactures in Japan and seventy percent of seal rings used in hydraulic transmission systems on vehicles. By July 18 auto companies began to announce plant shutdowns due to lack of these key components starting July 19. The auto plants stayed shut until the Riken re-started some of its production lines on July 22, allowing the automakers to resume production as of July 25. The effects of the earthquake on output, however, will be felt for another few weeks. Fujio Cho, Chairman of Toyota and the Japanese Automobile Manufacturers Association (JAMA), told the press on July 25 that the assembly plants would not resume full operation until the end of the mid-August holidays. Toyota President Katsuaki Watanabe announced his firm missed production of 60,000 vehicles, and depending on the source, nationwide production was delayed on 100,000-120,000 cars, buses and trucks, considerably more than the 40,000 units of lost production caused by the massive 1995 Kobe quake. New-car sales in the domestic market will temporarily decline, Cho said, noting that popular cars are out of stock at some dealerships because of suspended production.

13. (SBU) The shutdowns and production delays are not expected to have a major impact on the industry, automakers' overall production or bottom lines. (Note: Eight percent of the total Japanese work force -- 4.95 million people, of which 820,000 work

in manufacturing -- are involved in the auto industry according to JAMA. Endnote.) The main shutdown period of July 19-24 spanned a weekend and only three or four days of full production were lost: At Nissan, a company official told us their plants were down for just three days. Although the press reports some grumbling on the part of workers who may be working overtime or during holidays, a Honda official's remarks to us that that Honda can compensate by boosting production generally confirmed the press accounts of the industry's ability to make up lost production. One of the big investment houses shared their "instant" analysis with us, estimating a loss of 20 billion yen per day for halted production collectively for the automakers. This could be made up by year end by increased production in the second and third quarters. Toyota's President Watanabe independently confirmed the same in a statement to the press. The Big Three Japanese automakers -- Toyota, Honda and Nissan -- all told the media that the shutdowns would not affect exports.

Debate Over the Just In Time -- Lean Production System

14. (SBU) The press has questioned Japanese automakers' just in time or lean production systems which focus on keeping minimal inventories. Widely acknowledged to be an effective production method during normal times, its strength now seems to be a major weakness. The industry and government, however, are disputing this criticism. A JAMA representative told us the cynicism displayed by the Japanese press toward the just in time-lean production system was unfounded. It is a system that works and strikes the correct balance in managing risks and costs.

15. (SBU) A METI official added that, in fact, the principles of the system were used to mitigate the consequences of the quake.

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He underscored, moreover, the response was in accordance with pre-planned procedures the auto companies have developed to confront past production stoppages. Since an emergency and its effect on parts production cannot be predicted, the trick is to have a flexible workforce rather than a stockpile of "gadgets." For example, he recounted, a while ago, a Toyota seat-making plant in the Philippines was hit by a labor strike. Observers had expected Toyota to stockpile seats as a precaution. Toyota did not, and when the walkout occurred, Toyota instead sent middle-aged Japanese women with seat-sewing experience to continue production. Similarly, the carmakers' quick dispatch of some 700 workers to the damaged Riken plant demonstrated the resiliency of a production system that emphasizes labor flexibility rather than inventory stockpiles when confronted by a disaster. It was a very sophisticated response with logistics and support people being sent as well as engineers, the former arranging for housing and transport, freeing up the latter to do their primary work. (An industry insider explained to us that much of the equipment used by the automakers to produce engines is similar to the machinery at Riken. Thus, with the closure of the production lines, maintenance workers and engineers could be dispatched to Riken to repair the damage.)

16. (SBU) Consulate Nagoya notes that Japanese automakers also may keep more inventory readily available than is generally understood, particularly for strategically important or single-sourced parts. On the plant floor, the just-in-time system may result in as little as two hours of inventory on hand, but depending on the part, nearby warehouses owned by the automakers can stock several days of supplies. The JAMA representative added that there is already some seasonal variation in inventories to take into account the possibility of a heavy snowfall interrupting the delivery of components parts from a snow-bound parts supplier.

Worries Over Manufacturing Supply Chain Vulnerabilities

17. (SBU) Although the industry may have dodged a bullet this time, the quake revealed an unexpected vulnerability -- at least to the general public and the press -- to Japanese manufacturing

supply chains and has led to some fretting about other weak points, where one company has a large market share of a critical product. In the auto sector, several manufacturers have dominant market shares for other critical parts, e.g.: Denso Corp. has 60 percent of the car air conditioner market; Asmo Co. supplies 53 percent of radiator fans; and Tokai Rika produces 49.4 percent of the electrical switches. The quake also affected production at other companies such as Canon and additional electrical machinery and precision equipment manufacturers which rely on supplies from spring manufacturer Advanex, whose Kashiwazaki factory was also damaged. A Sanyo Electric chip making subsidiary stopped production temporarily due to the quake; the facility had suffered major damage from an earlier earthquake, which at the time caused a decline in Sanyo's earnings.

18. (SBU) The Japanese press highlighted other industries that are vulnerable to disruption, the effects of which would not only be felt in Japan, but globally. The Yomiuri wrote that the 1995 Kobe earthquake heavily damaged Kobe Steel's facilities, greatly disrupting the production of wire rods for valve springs on vehicle engines; with Kobe Steel's 50 percent of the global market share, the production of autos around the world was affected. The Yomiuri warned that Kobe Steel's Moka plant in Moka and Furukawa Electric Co.'s Nikko plant, both in Tochigi Prefecture, are the sole world-wide manufactures of a substrate needed for the production of hard disks for personal computers and HD-DVD players, and Kuraray Co. has a share of about 80 percent of the global market share in polyvinyl alcohol film which is used for a liquid crystal displays.

19. (SBU) One Yomiuri editorial writer also used the quake as hook to expound on the dangers of foreign investment, noting on August 1 that, "If a foreign company succeeds in a hostile takeover bid against Riken, all Japanese automakers will have their lifeline controlled by the foreign firm." Post has heard similar anti-FDI rhetoric before and does not think this opinion piece will have much impact -- the Yomiuri is the largest daily in Japan but is not the opinion leader on economic matters -- yet it is symbol of the depth of feeling here in some quarters about FDI and the lengths they will go to make their case.

The Aftermath

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110. (SBU) Despite the relative success of the auto industry's response, producers are hedging their bets. The JAMA representative emphasized that the quake provided a good opportunity to review supply chains and become more aware of problems resulting from concentration of production in one plant or area. Also, METI is recommending checking supply chains using a U.S. methodology to assess risk. Many big companies have already done this, but smaller companies have not. JAMA has called on the parts and vehicle manufacturers to consider producing at multiple locations. Toyota announced it would reexamine its supply network to see if dominant manufacturers' production can be dispersed. Riken is looking to distribute its production in Japan and as well as to China, the United States and Europe.

Comment

111. (SBU) The roll out of statistics in the Japanese press of the dominant market position enjoyed by certain component suppliers combined with the concentration of production in a few key plants is impressive for its implications were a major natural disaster to strike a central manufacturing area of Japan. As the Japanese auto-makers take stock of their manufacturing supply chain, identifying manufacturing vulnerabilities in Japan that could affect the global economy could be helpful preparation for the next big quake. Post expects the quake to give further encouragement to ongoing contingency preparations and disaster planning on the part of Japanese industry. Toyota, which is a proven learner as a company, will use the lessons of the quake to

strengthen its operations and risk management practices.
SCHIEFFER